

Message Text

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R 191851Z APR 78
FM AMEMBASSY BONN
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INFO AMEMBASSY BERN
AMEMBASSY BRUSSELS
AMEMBASSY COPENHAGEN
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AMEMBASSY ROME
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TAGS: EFIN, EINV, ETRD, GW
SUBJECT: HIGHLIGHTS OF THE BUNDESBANK'S 1977
ANNUAL REPORT

1. THE FOLLOWING ARE POINTS OF INTEREST EXTRACTED FROM
THE ADVANCE COPY OF THE BUNDESBANK'S 1977 ANNUAL
REPORT. THE EMBASSY WILL FORWARD COPIES OF THE GERMAN
AND ENGLISH LANGUAGE VERSIONS OF THE REPORT UPON
RECEIPT.

2. A) INTERNATIONAL MONETARY DEVELOPMENTS AND POLICY.
US BALANCE OF PAYMENTS:
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THE BUNDESBANK ATTRIBUTED THE US TRADE AND CURRENT
ACCOUNT DEFICIT IN 1977 MAINLY TO INCREASED US OIL
IMPORTS, AND, TO A LESSER EXTENT, TO MORE RAPID
ECONOMIC EXPANSION IN THE US THAN IN OTHER INDUSTRIAL
COUNTRIES. ACCORDING TO THE BUNDESBANK THE SECOND
FACTOR FAVORED JAPANESE EXPORTS IN PARTICULAR. THE
BUNDESBANK NOTES THAT IN 1977 CENTRAL BANKS PURCHASED

A RECORD VOLUME OF US DOLLARS IMPLYING " THAT THE US DEFICITS WERE ULTIMATELY FINANCED BY FOREIGN CENTRAL BANKS". THE BUNDESBANK WARNED THAT THE US DEFICIT CANNOT IN FUTURE BE FINANCED TO THE ME EXTENT BY CENTRAL BANKS AS THIS CREATES DANGER OF WORLD-WIDE INFLATION SUCH AS PREVAILED AT THE BEGINNING OF THE 70'S. FINANCING SHOULD BE ACCOMPLISHED THROUGH PRIVATE CAPITAL FLOWS. CHANCES FOR THIS APPEAR GOOD. INVESTMENT IN US CAPITAL MARKETS WILL AGAIN BE ATTRACTIVE FOR FOREIGN INVESTORS ONCE FINANCIAL MARKETS ARE CONVINCED THAT THE DOLLAR HAS FOUND A NEW BASIS. IN ADDITION, A REDUCTION OF DIFFERENCES IN ECONOMIC DEVELOPMENTS BETWEEN THE US, EUROPE AND JAPAN WOULD CONTRIBUTE TO AN IMPROVEMENT OF THE US CURRENT ACCOUNT. DUE TO JAPANESE AND FRG EFFORTS TO INCREASE DOMESTIC DEMAND, CONDITIONS TO ACHIEVE THIS HAVE IMPROVED. MOREOVER, THE BUNDESBANK EXPECTS THAT THE US OIL DEFICIT IN 1978 WILL INCREASE ONLY SLIGHTLY AND POSSIBLY EVEN DECLINE. IN THE BANK'S OPINION A RESOLUTE US ENERGY POLICY WOULD CONTRIBUTE TO A STABILIZATION OF THE DOLLAR EVEN IF THE ACTUAL EFFECTS ON THE US CURRENT ACCOUNT ARE NOTICEABLE ONLY LATER.

3. US INTERVENTION POLICY:

IN THE BUNDESBANK'S VIEW US AUTHORITIES REMAINED UNCLASSIFIED

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PASSIVE FOR A LONG TIME WITH REGARD TO THE DOLLAR'S DECLINE AND, THEREBY, CREATED THE IMPRESSION THAT THEY WERE NOT TOO CONCERNED ABOUT THE DOLLAR WEAKNESS. THE BUNDESBANK NOTED THAT EXTERNAL CONSIDERATIONS HAVE A LOWER PRIORITY FOR THE US COMPARED TO COUNTRIES WITH HIGH DEPENDENCE ON FOREIGN TRADE. DESSPITE THIS ONE HAD TO ASSUME THAT US AUTHORITIES CONSIDERED SUCH A DEVALUATION OF THE DOLLAR AS A USEFUL MEANS OF REDUCING US TRADE AND CURRENT ACCOUNT DEFICITS.

IN THE BUNDESBANK'S VIEW, LIMITS FOR USING EXCHANGE RATE MOVEMENTS AS AN INSTRUMENT FOR BALANCE OF PAYMENTS ADJUSTMENTS ARE NARROWER FOR THE US THAN FOR OTHER COUNTRIES BECAUSE THE DOLLAR CONTINUES TO PLAY A DOMINANT ROLE IN THE WORLD-WIDE SYSTEM OF FLOATING CURRENCIES. IN THE FORESEEABLE FUTURE THE DOLLAR CANNOT BE REPLACED AS THE MOST IMPORTANT TRANSACTION, INVESTMENT, AND RESERVE CURRENCY. THUS, IN THE

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BUNDESBANK'S VIEW, THE DESIRE FOR A STRONG AND STABLE
DOLLAR IS JUSTIFIED. THE BUNDESBANK ARGUES THAT IN THE
LONG RUN THE STABILITY OF THE DOLLAR CAN ONLY BE SECURED
BY ECONOMIC POLICIES ORIENTED AT BOTH INTERNAL AND
EXTERNAL EQUILIBRIUM. WITH REGARD TO THE MARCH
U.S.-GERMAN MONETARY ARRANGEMENT THE BUNDESBANK STATED
THAT THIS ARRANGEMENT HAS PARTICULAR IMPORTANCE SINCE
IT "DOCUMENTS THE WILL OF THE U.S. TO CONTRIBUTE TO A
STABILIZATION OF FOREIGN EXCHANGE MARKETS BY EMPLOYING
ITS OWN MONETARY RESERVES."

4. EXCHANGE RATE DEVELOPMENTS:
THE BUNDESBANK CALCULATED THAT THE WEIGHTED EXTERNAL
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VALUE OF THE US DOLLAR DECLINED BY ONLY ABOUT

2 PERCENT FROM THE BEGINNING OF 1977 TO THE END OF MARCH 1978. HOWEVER, EXCLUDING THE DOLLAR'S REVALUATION AGAINST THE CANADIAN DOLLAR, THE DOLLAR FELL BY MORE THAN 13 PERCENT IN COMPARISON TO CURRENCIES OF OTHER LARGE INDUSTRIALIZED COUNTRIES. THE BUNDESBANK ARGUES THAT "THIS CAN NO LONGER BE JUSTIFIED BY PRICE AND COST DIFFERENTIALS BETWEEN THE US AND OTHER COUNTRIES".

WITH REGARD TO THE DEUTSCHEMARK THE BUNDESBANK SAID THAT IN THE PERIOD JANUARY-OCTOBER 1977 THE REVALUATION OF THE DM WAS IN LINE WITH INFLATION DIFFERENTIALS AND THUS THE "REAL" EXTERNAL VALUE OF THE DEUTSCHEMARK REMAINED AT ABOUT ITS END-OF-1976 LEVEL. IN THE FOLLOWING MONTHS, HOWEVER, THE REAL EXTERNAL VALUE OF THE DEUTSCHEMARK INCREASED CONSIDERABLY, ACCORDING TO THE BUNDESBANK BY ABOUT 4 PERCENT BY MARCH 1978. THE BUNDESBANK FEELS THAT THIS REVALUATION COULD BE A SUBSTANTIAL BURDEN FOR THE GERMAN ECONOMY IN THE SHORT RUN PARTICULARLY BECAUSE IT COINCIDES WITH WEAK DOMESTIC ECONOMIC ACTIVITIES. THE BUNDESBANK CONCLUDES, IT WOULD BE "VERY UNDESIRABLE IF GERMAN EFFORTS TO ACHIEVE STRONGER ECONOMIC GROWTH ARE UNDERMINED BY DESTABILIZING EFFECTS ON THE DEUTSCHEMARK EXCHANGE RATE EMANATING FROM ABROAD".

5. "LOCOMOTIVE THEORY":

THE BUNDESBANK WRITES THAT DIFFERENCES OF OPINION ABOUT WHETHER THE FRG COULD TAKE OVER THE ROLE OF A "LOCOMOTIVE" FOR THE WORLD ECONOMY HAVE NOW BEEN REPLACED BY THE CONVICTION THAT COMMON EFFORTS ARE NECESSARY TO INITIATE A WORLD-WIDE ECONOMIC GROWTH

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PROCESS. THE BANK WARNS, HOWEVER, THAT WITH REGARD TO INCREASED WORLD GROWTH THE DANGER OF INFLATION SHOULD NOT BE FORGOTTEN. ACCORDING TO THE BANK THE 6.5 PERCENT INCREASE IN US CONSUMER PRICES IN 1977 WAS "FAR ABOVE A LEVEL WHICH IS DESIRABLE IN VIEW OF THE INTERNATIONAL ROLE OF THE DOLLAR".

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6. ROLE OF SDR'S

THE BUNDESBANK IS OF THE OPINION THAT THE DESIRE TO
MAKE SDR'S THE MAIN RESERVE MEDIUM OF THE MONETARY
SYSTEM DOES NOT JUSTIFY CREATION OF ADDITIONAL
LIQUIDITY IN THE FORM OF SDR'S, PARTICULARLY SINCE
OTHER SOURCES OF RESERVE CREATION CONTINUE TO PRODUCE
UNCONTROLLED LIQUIDITY. GERMAN AUTHORITIES, ON THE
OTHER HAND, FULLY SUPPORT AN IMPROVEMENT IN THE
QUALITY OF SDR'S PARTICULARLY THROUGH MORE ATTRACTIVE
INTEREST RATES.

7. EUROPEAN MONETARY POLICY:

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THE BUNDESBANK EXPRESSED SCEPTICISM WITH REGARD TO
PROPOSALS TO REALIZE EC ECONOMIC AND MONETARY
UNION BY A "QUALITATIVE JUMP". SUCH PROPOSALS SHOULD
BE EXAMINED VERY CAREFULLY AND CRITICALLY,
PARTICULARLY SINCE EFFORTS IN 1971/72 TO ACHIEVE
SUCH A UNION CREATED MUCH DISAPPOINTMENT. THE
BUNDESBANK AGREES THAT ADDITIONAL PROBLEMS FOR EC

COUNTRIES WERE CREATED BY THE TENSIONS IN THE INTERNATIONAL MONETARY SYSTEM AND THAT A COMMON EC ECONOMIC AND MONETARY POLICY IS MORE URGENT THAN EVER. HOWEVER, CHANCES OF ACHIEVING THIS WOULD BE IMPROVED BY EMPLOYING "GRADUAL AND PRAGMATICALLY WORKED-OUT STEPS".

8. INDEBTEDNESS OF DEVELOPING COUNTRIES:

INDEBTEDNESS OF THE LDC'S IS NOW BETTER THAN WAS EXPECTED A YEAR AGO. ONLY A FEW COUNTRIES REALLY ENCOUNTERED SERIOUS REFINANCING DIFFICULTIES. HOWEVER, THE FACT THAT BORROWINGS ON INTERNATIONAL FINANCIAL MARKETS REPRESENT AN INCREASINGLY HIGHER SHARE OF TOTAL FOREIGN INDEBTEDNESS OF LDC'S MAKES THE JUDGEMENT OF COUNTRY RISKS BY THE LENDING BANKS MUCH MORE IMPORTANT.

9. B) DOMESTIC DEVELOPMENTS

FRG BALANCE OF PAYMENTS"

THE BUNDESBANK POINTED OUT THAT IN 1977 THE FRG'S CURRENT ACCOUNT SURPLUS DECLINED BY DM 1 BILLION TO DM 8.7 BILLION (ACCORDING TO REVISED DATA AS PUBLISHED IN THE BUNDESBANK'S ANNUAL REPORT - SEE BONN 6872). IT AMOUNTED TO 0.7 PERCENT OF NOMINAL GERMAN GNP AS COMPARED WITH 0.9 PERCENT IN 1976 AND 1.0 PERCENT IN 1975. THE BUNDESBANK FEELS THAT

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FURTHER REDUCTION OF THE FRG'S SURPLUS POSITION HAS ITS LIMITS. THE BANK ARGUES THAT DECLINING FRG EXPORTS WEAKEN DOMESTIC PRODUCTION DUE TO THE ECONOMY'S HIGH EXPORT DEPENDENCE. THIS IN TURN REDUCES IMPORTS SINCE A SUBSTANTIAL PORTION OF GERMAN IMPORTS ARE LINKED TO THE LEVEL OF OVERALL PRODUCTION. IN VIEW OF THIS RELATIONSHIP THE BUNDESBANK SAYS A WEAKENING OF EXPORTS CANNOT BE EXPECTED TO BE OFFSET BY INCREASED DOMESTIC DEMAND IN THE SHORT RUN, AND, THEREFORE, CURRENT ACCOUNT DEFICITS CANNOT BE EXPECTED IN SUCH A CASE.

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IN SUM, THE BUNDESBANK FEELS THAT IN 1977 THE FRG
CAME NEAR EXTERNAL EQUILIBRIUM, PARTICULARLY SINCE
LONG-TERM CAPITAL EXPORTS MORE THAN OFFSET THE CURRENT
ACCOUNT SURPLUS. THUS, IN THE BANK'S VIEW, THE FRG
HAS NOT AGGRAVATED EFFORTS OF OTHER COUNTRIES TO
BALANCE THEIR EXTERNAL PAYMENTS POSITION BUT RATHER
FACILITATED SUCH EFFORTS.

10. OVERALL ECONOMIC DEVELOPMENTS:

THE BUNDESBANK JUDGED 1977 ECONOMIC RESULTS IN
THE FRG AS UNSATISFACTORY WITH REGARD TO REAL GROWTH
AND REDUCING UNEMPLOYMENT. THE BANK ATTRIBUTED THIS
TO LOW FOREIGN DEMAND, COST INCREASES AT HOME AND
LOWER-THAN-PLANNED NET PUBLIC SECTOR SPENDING (SEE
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PARAGRAPH 12). THE BANK POINTS OUT THAT IN THE LONG-
TERM (1973-1977) GROWTH OF GERMANY'S PRODUCTIVE
CAPACITY DECELERATED. IN ADDITION, UTILIZATION OF EXISTING PRODUCTIVE

CAPACITY WAS AT A SUBNORMAL LEVEL. HOWEVER, THE BANK
ESTIMATES THAT HAD EXISTING CAPACITY BEEN UTILIZED AT A
"NORMAL " LEVEL, REAL GNP AT THE END OF 1977
WOULD HAVE BEEN ONLY ABOUT 3 PERCENT HIGHER (COM-

PARSED WITH A 5 PERCENT FIGURE AS CALCULATED BY THE COUNCIL OF ECONOMIC EXPERTS). THE BUNDESBANK ATTRIBUTED THE DECLINE IN GROWTH POTENTIAL MAINLY TO LOWER INVESTMENT WHICH, IN ITS VIEW IS THE RESULT OF BASIC CHANGES IN ECONOMIC CONDITIONS SUCH AS DECLINING POPULATION SINCE 1974, HIGHER ENVIRONMENTAL COSTS, SLOWER TECHNOLOGICAL PROGRESS, CHANGES IN INCOME DISTRIBUTION IN FAVOR OF LABOR AND THE GRADUAL APPRECIATION OF THE DEUTSCHEMARK SINCE END OF THE SYSTEM OF FIXED EXCHANGE RATES. (THE BUNDESBANK ADMITTED THAT IN THE PAST THE UNDERVALUATION OF THE DEUTSCHEMARK WAS IN EFFECT AN "EXPORT SUBSIDY"). IN THE BUNDESBANK'S VIEW THESE FACTORS WILL CONTINUE TO EFFECT INVESTMENT IN FRG.

11. DOMESTIC MONETARY EXPANSION:

IN 1977 THE BUNDESBANK PERMITTED MONETARY EXPANSION SUBSTANTIALLY IN EXCESS OF ITS MONETARY GROWTH TARGET BECAUSE IT FELT A CONTINUATION OF THE REAL REVALUATION OF THE DEUTSCHEMARK COULD BECOME A SERIOUS HINDRANCE FOR DOMESTIC ECONOMIC RECOVERY. THUS, DOMESTIC DEMAND HAD TO BE STIMULATED MORE FROM THE MONETARY SIDE THAN OTHERWISE WOULD HAVE BEEN JUSTIFIED. MOREOVER, DUE TO THE DM REVALUATION DOMESTIC PRICE INCREASES UNCLASSIFIED

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WERE DAMPENED IN THE SHORT RUN AND THUS REPERCUSSIONS OF THE STRONG MONETARY EXPANSION ON THE PRICE LEVEL WERE ACCEPTABLE. IN THE LONGER RUN, HOWEVER, THE POTENTIALLY INFLATIONARY IMPACTS OF SUCH MONETARY EXPANSION SHOULD BE AVOIDED.

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12. FRG DEFICIT SPENDING:
IN 1977 THE FRG'S PUBLIC SECTOR DEFICIT WAS LOWER
THAN EXPECTED. EXPENDITURES WERE 1 PERCENT LOWER
THAN ORIGINALLY PLANNED AND REVENUES ROSE BY 11 PERCENT
AS COMPARED WITH AN EXPECTED 9 1/2 PERCENT INCREASE.
AS A RESULT, THE 1977 DEFICIT OF PUBLIC AUTHORITIES
(EXCLUDING THE SOCIAL SECURITY SYSTEM) WAS ONLY
DM 32 BILLION AS COMPARED WITH DM 40 BILLION PRO-
JECTED IN LATE SPRING 1977. FOR 1978 THE BUNDESBANK
EXPECTS A TOTAL PUBLIC SECTOR DEFICIT (INCLUDING
THE SOCIAL INSURANCE SYSTEM) OF ABOUT DM 60-65 BILLION.
COMPARED WITH 1977 THIS WOULD MEAN AN EXPANSIONARY
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SWING OF ABOUT DM 20-25 BILLION. IN RELATION TO
GNP (NATIONAL ACCOUNTS DEFINITION SINCE OTHER
INTERNATIONAL COMPARISONS ARE NOT AVAILABLE) THIS WOULD
MEAN A TOTAL PUBLIC SECTOR DEFICIT OF ABOUT 4 1/2 PER-
CENT OF GNP AS COMPARED WITH 2 3/4 PERCENT IN 1977.
IN THE BUNDESBANK'S VIEW THIS IS VERY HIGH BY INTER-
NATIONAL STANDARDS SINCE IN 1978 PUBLIC SECTOR DEFICITS
IN THE US WILL PRESUMABLY BE ONLY 1 PERCENT OF GNP.
LIKE CALCULATIONS FOR FRANCE AND BRITAIN RESULT IN
3 1/2 PERCENT AND 1 PERCENT, RESPECTIVELY, EVEN
THOUGH, THE BUNDESBANK NOTES, UNEMPLOYMENT IS A MORE
SERIOUS PROBLEM IN THESE COUNTRIES. IN THIS REGARD
THE BUNDESBANK UNDERLINED REPEATED STATEMENTS OF
THE FEDERAL GOVERNMENT THAT THE FRG HAS NOW REACHED
ITS LIMIT FOR A JUSTIFIABLE EXPANSION OF PUBLIC SECTOR

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